Ketua Pengarah Hasil Dalam Negeri v International Foods Sdn Bhd

HIGH COURT (KUALA LUMPUR) — TAX APPEAL NO R2-14-9 OF 1998
AZMEL J
5 JUNE 2000

Revenue Law *— Income tax — Deduction — Cost of efficiency study and retrenchment exercise — Company voluntarily liquidated at the end of period of efficiency study and amalgamated with another subsidiary company — Retrenchment exercise conducted 16 days before voluntary liquidation — Whether expenses were allowable deductions — Income Tax Act 1967 s 33(1)*

The respondent was a subsidiary of Nestle (M) Sdn Bhd. In June 1985, Nestle commissioned an efficiency study of its subsidiaries, including the respondent. The cost of the study for the period between June 1985 to 31 December 1985 was RM590,825 which was paid for by the respondent. In addition, a number of the staff of the respondent were retrenched in a retrenchment exercise on 15 December 1985 as it was found that their employment was redundant. It cost the respondent a sum of RM393,369 to pay their retrenchment benefits. On 31 December 1985, the respondent was placed in voluntary liquidation and the respondent and another subsidiary were amalgamated. The entire share capital of the respondent was acquired by that subsidiary ('the respondent's successor'). The respondent's factory was not shut down but continued to operate under the respondent's successor with the same employees. The respondent applied to have the expenditure incurred for the efficiency study and the retrenchment exercise treated as allowable deductions under s 33(1) of the Income Tax Act 1967, contending that they were wholly and exclusively incurred in the production of gross income. The Special Commissioners found for the respondent and allowed the deductions. The appellant appealed.

Held, allowing the appeal:

(1) The efficiency study was not wholly and exclusively for the purpose of increasing the efficiency of the respondent and thereby increasing its income producing capacity as there was another purpose of the study: to liquidate the respondent, which was in fact liquidated (see p 106G–H).

(2) The efficiency study was meant mainly for the benefit of the respondent's successor, a completely different legal entity, who took over the business of the respondent (see p 107I–108B).

(3) The retrenchment exercise was made on 15 December 1985 and the respondent was placed in voluntary liquidation on

A 31 December, a difference of only 16 days. The irresistible conclusion to be derived is that the retrenchment exercise was done for the benefit of the respondent's successor (see p 109D–E).

B **[Bahasa Malaysia summary**

Penentang merupakan sebuah subsidiari Nestle (M) Sdn Bhd. Pada bulan Jun 1985, Nestle telah menjalankan suatu kajian kecekapan ke atas subsidiarinya, termasuk penentang. Kos untuk kajian tersebut untuk tempoh antara Jun 1985 hingga 31 Disember 1985 adalah
C RM590,825 yang dibayar oleh penentang. Tambahan lagi, sebilangan kakitangan penentang telah diberhentikan dalam satu pelaksanaan pengurangan perbelanjaan pada 15 Disember 1985 kerana ia didapati penggajian mereka dianggap tidak diperlukan. Penentang terpaksa menanggung perbelanjaan sebanyak RM393,369 untuk membayar
D faedah pengurangan perbelanjaan. Pada 31 Disember 1985, penentang telah diletakkan di bawah penyelesaian sukarela dan penentang dan satu lagi subsidiari telah digabungkan. Keseluruhan modal penentang telah diperolehi oleh subsidiari itu ('pengganti penentang'). Kilang penentang tidak ditutup tetapi terus beroperasi di bawah pengganti penentang dengan pekerja-pekerja yang sama.
E Penentang telah membuat permohonan agar perbelanjaan yang ditanggung untuk kajian kecekapan dan pelaksanaan pengurangan perbelanjaan dianggap sebagai tolakan yang dibenarkan di bawah s 33(1) Akta Cukai Pendapatan 1967, dengan berhujah bahawa mereka telah ditanggung secara keseluruhan dan eksklusif dalam hasil pendapatan kasar. Pesuruhjaya-Pesuruhjaya Khas memutus memihak
F kepada penentang dan membenarkan tolakan tersebut. Perayu mengemukakan rayuan.

Diputuskan, membenarkan rayuan:

G (1) Kajian ke atas kecekapan tidak dijalankan secara keseluruhan dan eksklusif untuk tujuan meningkatkan kecekapan penentang dan dengan itu meningkatkan keupayaannya untuk menghasilkan pendapatan kerana terdapat tujuan lain di sebalik kajian tersebut: untuk menggulung penentang, yang memang telah digulungkan
H (lihat ms 106G–H).

(2) Kajian tersebut ke atas kecekapan dimaksudkan terutamanya untuk manfaat pengganti penentang, suatu entiti sah yang berlainan pada keseluruhannya, yang mengambil alih perniagaan penentang (lihat ms 107I–108B).

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(3) Pelaksanaan pengurangan perbelanjaan dibuat pada 15 Disember 1985 dan penentang telah diletakkan di bawah penyelesaian

sukarela pada 31 Disember, suatu perbezaan sebanyak 16 hari sahaja. Kesimpulan sukar ditolak yang dicapai adalah bahawa pelaksanaan pengurangan perbelanjaan telah dilakukan untuk manfaat pengganti penentang (lihat ms 109D–E).] A

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Notes

For cases on deduction of income tax, see 10 *Mallal's Digest* (4th Ed, 1999 Reissue) paras 2021–2056.

C

Cases referred to

Ampat Tin Dredging Ltd v DGIR [1982] 2 MLJ 46 (refd)
People's Insurance Co (M) Sdn Bhd v People's Insurance Co Ltd & Ors [1986] 1 MLJ 68 (refd)
W Nevill Co Ltd v FCU T (1937) 56 CLR 290 (refd)

D

Legislation referred to

Income Tax 1967 s 33(1)

Raja Kamarulzaman Raja Musa (Legal Officer, Inland Revenue Board) for the appellant. E

A Subramaniam (*Shook Lin & Bok*) for the respondent.

Azmel J: This is an appeal by Ketua Pengarah Hasil Dalam Negeri, the appellant, against the deciding order of the Pesuruhjaya Khas Cukai Pendapatan dated 1 September 1998. There are two main issues being raised at the appeal before this court, namely: F

(i) whether the sum of RM590,825 incurred and paid in 1985 to Alexander Proudfoot (M) Sdn Bhd by the respondent to conduct an efficiency study to increase productivity and reduce costs in the respondent's business is an expense wholly and exclusively incurred in the production of gross income and deductable under s 33(1) of the Income Tax 1967 ('the Act'); and G

(ii) whether the sum of RM393,369 incurred and paid in 1985 by the respondent to certain redundant employees of the respondent as gratuity/retrenchment benefits is an expense wholly and exclusively incurred in the production of gross income under s 33(1) of the Act. H

The Pesuruhjaya Khas Cukai Pendapatan in their deciding order had ruled that both the two sums as mentioned above are expenditure which are deductible under s 33(1) of the Act. It was against this ruling that this appeal was filed by the appellant to this court. I

A The facts of the case are briefly as follows. The respondent, a subsidiary of Nestle (M) Sdn Bhd was incorporated on 7 November 1970 and commenced business in July 1971. On 25 June 1985, Nestle (M) Sdn Bhd, the parent company of the respondent, commissioned Alexander Proudfoot (M) Sdn Bhd to conduct an efficiency study of its subsidiaries including the respondent. The respondent and another subsidiary company, Food B Specialities (M) Sdn Bhd, were amalgamated and the entire share capital of the respondent was acquired by Food Specialities (M) Sdn Bhd. As a result of the efficiency study the respondent was placed in voluntary liquidation on 31 December 1985. However, the respondent's factory was not shut down on 31 December 1985 but continued operation under Food C Specialities (M) Sdn Bhd with the same employees. The cost of the study for the period between June 1985 to 31 December 1985 was RM590,825 and was paid by the respondent. In addition, resulting from the efficiency study, a number of staff of the respondent were retrenched as it was found that their employment was redundant. It cost the respondent a sum of RM393,369 to pay their retrenchment benefits. The retrenchment exercise D was carried out on 15 December 1985.

It was the respondent's application to have the two amounts of expenditure (RM590,825 and RM393,369) treated as allowable deductions under s 33(1) of the Act, claiming that they were expenses wholly and exclusively incurred in the production of gross income. The E appellant totally disputed this claim by the respondent.

Section 33(1) of the Act which is the relevant provision of law under which the dispute arises, reads as follows:

> Subject to this Act, the adjusted income of a person from a source for the basic F period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including...

I shall now consider the first issue concerning the expenses in conducting G the efficiency study by Alexander Proudfoot (M) Sdn Bhd amounting to RM590,825. It was contended by the respondent that the conducting of the efficiency study was to increase its productivity and reduce business costs and as such, it was an expense wholly and exclusively incurred in the production of gross income and hence is an allowable deduction under s 33(1) of the Act.

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The Special Commissioners agreed with such contention. It was the finding of the Special Commissioners that as a result of the efficiency study which commenced in June 1985 there was an increase of 10% in speed time in production by September 1985. There was a reduction in non-productive time and an improvement in plant maintenance. The Special I Commissioners had relied on the Australian case of *W Nevill Co Ltd v FCUT* (1937) 56 CLR 290 and quoted the decision of Lotham CJ as follows:

> The facts of this case show that the expenditure was actually incurred in gaining or producing the assessable income of the year in question. The expenditure was made for the purpose of increasing the efficiency of the company and therefore increasing its income producing capacity. It was not a capital expenditure, it was, in my opinion, an expenditure incurred in the course of gaining or producing assessable income.

The Special Commissioners then arrived at the following conclusion:

> Since the appellant/(respondent) had incurred the expenses for the efficiency study, which had benefited it by reducing employees and increasing productivity it was 'an expenditure incurred in the course of gaining or producing assessable income' — *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295.

In his submission, counsel for the appellant contended that in arriving at their decision the Special Commissioners had failed to give full consideration to certain material facts. One of the material facts that they failed to consider was the legal implication of the fact that the respondent was in the process of being amalgamated with another subsidiary, Food Specialities (M) Sdn Bhd. And the respondent's assets, business and employers were in fact transferred to Food Specialities (M) Sdn Bhd on 31 December 1985 and on which date the respondent was voluntarily liquidated. This is an 'admitted fact' as stated by the Special Commissioners. It cannot be conveniently ignored that the efficiency study led to the liquidation of the respondent.

In the light of the above, it is inconceivable how the Special Commissioners could arrive at the conclusion that the efficiency study was wholly and exclusively for the purpose of increasing the efficiency of the respondent and therefore increasing its income producing capacity when there also appeared to be another important purpose of the study that was to liquidate the respondent which, in fact, was voluntarily liquidated on 31 December 1985. Even though the respondent's factory continued to operate and its employees continued to be employed, it does not mean the respondent continued to exist after its liquidation. In reality, its business had been taken over by another subsidiary company, Food Specialities (M) Sdn Bhd. With such takeover of its business and after its liquidation, the respondent had ceased to exist. Food Specialities (M) Sdn Bhd, which took over the respondent's business, is a completely different legal entity. This was so stated by Zakaria Yatim J (as he then was) in the case of *People's Insurance Co (M) Sdn Bhd v People's Insurance Co Ltd & Ors* [1986] 1 MLJ 68 where his Lordship said at pp 69–70:

> The plantiff company is a legal entity by itself. Although it is a subsidiary of the first defendant company, the plaintiff company maintains its own separate entity. In *Ebbw Vale Urban District Council v South Wales Traffic Area Licensing Authority,* Cohen LJ said:
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> > 'Under the ordinary rules of law, a parent company and subsidiary company even a 100 percent subsidiary company are distinct legal entities ...'

Following the decision of Zakaria Yatim J in the *People's Insurance* case above, the respondent was a legal entity completely different from its parent company, Nestle (M) Sdn Bhd. It therefore follows that the respondent was also a legal entity completely different from the other subsidiary companies including Food Specialities (M) Sdn Bhd. The respondent was voluntarily liquidated on 31 December 1985. The efficiency study was carried out for the period between June 1985 and 31 December 1985. For whose benefit was this study conducted? Was it really meant for the benefit of the respondent which was liquidated on 31 December 1985 and on which date the study was said to have been completed? Based on the above circumstances, I find it almost impossible to accept the contention that the efficiency study was meant for the benefit of the defunct company.

Having regard to the facts and circumstances of this case, I arrived at the conclusion that the efficiency study was meant mainly for the benefit of the respondent's successor, Food Specialities (M) Sdn Bhd. In addition, I am also unable to agree with the finding of the Special Commissioners that as a result of the study there was an increase of 10% in speed time in production. In my view, this could not be true because the retrenchment of the staff only took place on 15 December 1985 whereas the 10% increase was for the period between June and September 1985. During that period, no staff of the respondent had been retrenched yet. My reasons for being unable to agree with the finding of the Special Commissioners are as follows. In the first place, during that period the same number of employees were still employed, which means every employee must have participated in the production. Secondly, the implementation of any study conducted by a company would normally commence after the completion of the study. It struck me as rather odd that the study was implemented well before it was completed. It is common knowledge that before any study is implemented the board of the company would make a decision whether to accept or reject it. If accepted, the implementation of the study would only commence after its completion ie after 1 January 1986, a date after the liquidation of the respondent. Thirdly, the determination of the effectiveness of the implementation of a new study would be taken on an annual basis. To base its effectiveness for a period of four months only would not have any real bearing. Therefore, using the result for the period between June and September 1985 instead of a period of one year would be too short a period and would not likely reflect the true result.

In the circumstances and for the reasons as stated above, I arrived at the conclusion that the efficiency study could not be said to be wholly and exclusively for the purpose of increasing the productivity and reduction of business costs of the respondent as evidence appeared to show that it was done more for the benefit of the respondent's successor, Food Specialities (M) Sdn Bhd. In addition, the 10% increase in speed time in production for the period between June and September 1985 could not be due to the retrenchment of staff exercise since it was in evidence that the retrenchment

only took place on 15 December 1985. As such the sum of RM590,825 could not fall within the meaning of an expense allowed to be deducted under s 33(1) of the Act.

I now come to the second issue which concerns the sum of RM393,369 being the expense incurred by the respondent to pay its redundant employees as gratuity/retrenchment benefits. The question to be decided is whether this sum comes within the meaning of an expense allowed to be deducted under s 33(1) of the Act. The Special Commissioners had ruled that such sum was an expense wholly and exclusively incurred in the production of gross income and therefore was an allowable deduction under s 33(1) of the Act.

After having carefully considered the facts and circumstances of this case, I arrived at the same conclusion as in the first issue. In other words, the expense incurred by the respondent amounting to RM393.369 towards payment of gratuity/retrenchment of the respondent's redundant employees is not an allowable deduction under s 33(1) of the Act. My reasons are as follows.

Firstly, it would appear from the facts and circumstances of this case that the intention of carrying out the efficiency study was to facilitate the takeover of the respondent by Food Specialities (M) Sdn Bhd. The facts clearly show that on 31 December 1985, the respondent was placed in voluntary liquidation and on the same date Food Specialities (M) Sdn Bhd took over the assets, business and employees of the respondent. Only on the basis of these facts the irresistible inference concluded was that the efficiency study was not intended to benefit the respondent. How could the respondent have benefited by the efficiency study when it went into liquidation on 31 December 1985 which was also the date of the completion of the efficiency study? In fact, the efficiency study continued to be conducted until February 1986 well after the respondent was voluntarily liquidated. No right thinking person, what more a company like Nestle (M) Sdn Bhd, would want to waste substantial amounts of money on conducting an efficiency study of a subsidiary that it had intended to be liquidated. In my view, that efficiency study was not done for the benefit of the respondent at all.

Secondly, when Food Specialities (M) Sdn Bhd took over from the respondent on 31 December 1985 it does not mean that the respondent still existed. On being liquidated, the respondent had found its grave. The retrenchment exercise was carried out on 15 December 1985. The liquidation of the respondent was on 31 December 1985. I am sure that well before the retrenchment exercise took place, the respondent was already gearing itself towards voluntary liquidation. Therefore, it is inconceivable that the retrenchment expenses could possibly be said to have been wholly and exclusively incurred in the production of gross income of the respondent. The case in point is *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 46. The headnotes state at p 46:

(2) The money expended on retrenchment benefits to the company's employees before winding up its business could not possibly be said to have been 'wholly and exclusively incurred in the production of gross income' within the ambit of s 33(1) of the Income Tax Act 1967.

(3) In the final analysis the question whether money is 'wholly and exclusively incurred in the production of gross income' within the meaning of s 33(1) of the Income Tax Act 1967 is a question of fact to be decided on the circumstances of each case and it is on the finding of those facts that a conclusion of law is arrived at.

Applying the principle as stated in *Ampat Tin Dredging*'s case the facts as found and also facts proved by the Special Commissioners were that the retrenchment exercise was made on 15 December 1985 and the respondent was placed in voluntary liquidation on 31 December 1985 ,a period of only 16 days. It must also be emphasized that the respondent was *voluntarily* liquidated. The timing of the retrenchment exercise was very close to the date of the takeover exercise of the respondent by Food Specialities (M) Sdn Bhd. On those facts, the irresistible conclusion to be derived is that the retrenchment exercise was done for the benefit of Food Specialities (M) Sdn Bhd, the successor of the respondent. Therefore, I find myself unable to agree that the retrenchment expense incurred by the respondent was wholly and exclusively in the production of the gross income of the respondent. From the facts, that does not appear to be the intention at all.

There could not be any doubt whatsoeverthat the intention to liquidate the respondent and its business be taken over by Food Specialities (M) Sdn Bhd existed well before the efficiency study was conducted on 25 June 1985. From the Foreign Investment Committee's letter dated 16 May 1985 in reply to an earlier application by Nestle (M) Sdn Bhd, the intention to amalgamate three subsidiary companies of Nestle (M) Sdn Bhd including the respondent and the takeover by Food Specialities (M) Sdn Bhd of the other two subsidiaries including the respondent was clearly stated (see exh F1). Nestle (M) Sdn Bhd's letter to the FIC must have been sent much earlier than 16 May 1985. In the light of such intention which existed before the conducting of the efficiency study I find it very difficult to agree that the expense incurred on the retrenchment of staff of the respondent was *wholly and exclusively* in the production of the respondent's gross income. The content of this letter, exh F1, strengthened my view that the retrenchment exercise was meant more to facilitate the takeover of the respondent by Food Specialities (M) Sdn Bhd.

For the reasons as stated above, I also concluded that the sum of RM393.369, expended towards the retrenchment of the redundant staff of the respondent was not an expense wholly and exclusively incurred in the production of gross income and therefore is not an allowable deduction under s 33(1) of the Act.

In the circumstances, I allowed this appeal with costs. A

Appeal allowed.

Reported by Andrew Christopher Simon

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